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TAX LITIGATION ISSUES

Expert Analysis

Getting Right With the IRS: The 'Fresh Start' Program

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The Great Recession has devastated many Americans, leaving them unable to pay their mortgages, credit card bills and, increasingly, their tax liabilities. In the past, the Internal Revenue Service has aggressively sought to collect past due taxes, interest and penalties, imposing liens and levies to squeeze funds from struggling taxpayers who genuinely lack the resources to meet their obligations.

Fortunately, the IRS has increasingly recognized the need to work with delinquent taxpayers seeking to resolve their tax problems without unduly adding to their financial burdens. Beginning in February 2011, the IRS implemented a "Fresh Start" initiative to provide individuals and small businesses with a number of options to mitigate their outstanding obligations. This initiative, which was expanded in the spring of 2012, apparently reflects a new, pragmatic approach by the IRS, recognizing the importance of working with taxpayers who are dealing with their tax liabilities in good faith and helping them dig out of their financial holes.

Historical Perspective

After the IRS assesses a tax liability, it sends a notice and demand for payment. If a taxpayer does not make a full and timely payment in response to that notice, the IRS can serve and file a Notice of Federal Tax Lien, which gives it legal claim to a taxpayer's property for the amount of an unpaid tax debt.[1] In her 2011 report to Congress, the National Taxpayer Advocate noted that the IRS imposed liens on over 1.1 million taxpayers in fiscal 2010.[2] In addition, the IRS can seek to levy, or legally seize, property or wages to satisfy a tax debt.

A tax lien is especially problematic because it stays on the taxpayer's credit report for seven years after it is released.[3] Because of this long-term impact and because of the critical role credit reports play in everyday commercial dealings, a tax lien "has the potential to render someone unemployable, unable to obtain housing (owned or rented), and unable to obtain car insurance or a credit card…for many years into the future."[4]

Over the years, the IRS has been repeatedly criticized for its aggressive use of liens and levies. Between 2006 and 2011, the National Taxpayer Advocate regularly assailed the IRS's policy of mechanically relying on tax liens and levies, arguing that the policy created additional and unnecessary hardships on taxpayers who were attempting to pay their tax debt obligations.[5] Among other things, the Taxpayer Advocate complained that the IRS's practice of automatically resorting to liens and levies as a collection mechanism without providing personal contact or flexible payment options failed to address the legitimate needs of taxpayers seeking to resolve their tax problems.[6] The Taxpayer Advocate has also criticized the IRS's failure to develop better standards for evaluating economic hardship cases before imposing tax liens and levies.[7]

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In 2009, the Tax Court addressed the IRS's aggressive collections policy in *Vinatieri v. Commissioner*.[8] The taxpayer in *Vinatieri* was a single mother who suffered from serious health problems and could only find part-time employment. According to a financial statement submitted to the IRS, her $800 monthly income barely covered her monthly expenses and her only assets were a car worth $300 and $14 in cash. Notwithstanding this clear economic hardship, the IRS proceeded to levy the taxpayer's wages to satisfy back taxes because she had failed to file her 2005 and 2007 tax returns. The Tax Court noted that, under the Internal Revenue Code, the IRS is required to release any levy that "creat[es] an economic hardship due to the financial condition of the taxpayer." Thus, the court concluded that, notwithstanding the unfiled returns, "[a] determination in a hardship case to proceed with a levy that must immediately be released is unreasonable and undermines public confidence that tax laws are being administered fairly."[9]

Offer in Compromise

Since 1992, the IRS has formally offered delinquent taxpayers an opportunity to settle their tax, interest and penalty obligations for less than the full amount owed by participating in its Offer in Compromise (OIC) program.[10] To apply for the program, taxpayers were required to submit an application fee, financial statements and disclosures, a non-refundable partial payment, and a proposed payment plan. When reviewing a taxpayer's proposal, the IRS would consider a taxpayer's assets and budget, including future earning potential. Moreover, if a taxpayer failed to comply with the payment plan or failed to file tax returns and make complete payments on tax liabilities in future years, he would be in breach of the OIC agreement and the IRS could pursue the original full amount of the taxes, interest and penalties (less any payments that had been made).

As with its use of tax liens and levies, prior to the Fresh Start initiative the IRS's policies regarding the OIC program had been criticized for being rigid and inflexible. One source of complaints was the IRS's method of calculating a taxpayer's assets and budgets when reviewing an offer. In calculating a taxpayer's assets, the IRS historically included losses suffered when the taxpayer dissipated assets (i.e., the full value of assets the taxpayer sold, even if they were liquidated at a discount).

Similarly, in computing the taxpayer's reasonable budget, the IRS used a national, as opposed to local, standard for living expenses and refused to recognize obligations such as federal student loan repayments and state and local tax obligations. Because of these calculations, many taxpayers who applied for the OIC program were denied relief, while many others were accepted but had their (reduced) obligations based on unfair assessments of their assets and liabilities.[11] Finally, both the Taxpayer Advocate and the Treasury Inspector General for Tax Administration also

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criticized the application fee and the partial payment requirement as a barrier to participation and pointed to administrative delays as unduly restricting access to the OIC program.[12]

The Fresh Start Program

The IRS has apparently taken criticisms of its collection and settlement practices to heart and, on Feb. 24, 2011, it announced two major reforms to its use of tax liens.[13] First, under the IRS's collections system, notices of liens are automatically filed once a taxpayer's liability reaches a certain threshold. Historically, the threshold was $5,000, which resulted in liens being imposed on low- to middle-income taxpayers. As part of the Fresh Start initiative, the IRS doubled this threshold to $10,000, effectively reducing the number of tax liens imposed and limiting their deleterious effect to taxpayers with more significant liabilities. Indeed, a recent IRS collection activity report shows that from October 2011 through March 2012, the IRS filed 41 percent fewer notices of tax liens than it did for a comparable period in 2011.[14]

Perhaps more important for affected taxpayers, the Fresh Start initiative includes a lien withdrawal program. Unlike a released lien, the record of a withdrawn lien is expunged from a taxpayer's credit report.[15] Under the Fresh Start initiative, individuals can apply to have liens withdrawn once they have made full payment of their outstanding taxes. Additionally, any taxpayer who has an outstanding tax liability of less than $25,000 can apply for a lien withdrawal even before full satisfaction of the debt by enrolling in the IRS's Direct Debit Installment Agreement program. Under this program, the IRS will withdraw a taxpayer's lien after a probationary period of direct debit payments.[16]

As part of the Fresh Start initiative, the IRS also amended the OIC program in a number of ways. First, the February 2011 announcement formalized the IRS's streamlined OIC program, which began as a pilot in 2010. The IRS requires less financial paperwork under the streamlined OIC program than under the traditional OIC program and expedites its review of offers, thereby making the process less burdensome for taxpayers. The February 2011 announcement expanded the streamlined program to include taxpayers with annual incomes of up to $100,000 and maximum tax liabilities of $50,000, which doubled the previous limit of $25,000.

In May 2012, the IRS announced further reforms to the financial criteria used to identify taxpayers eligible for the OIC program.[17] Among the amendments are changes in how the IRS determines the taxpayer's reasonable payment potential, including shortening the period for which the taxpayer's income will be considered and valuing the taxpayer's assets in a more realistic fashion. The Service also updated its allowable expense standards, allowing participants in the OIC program to include student loan and state and local tax payments in their budgeted expenses. Since an OIC agreement is based on the total value of the taxpayer's assets and his or her net monthly income after the standard expense allowance, the new policy will influence both sides of the calculation. This should allow more taxpayers to reach settlements with the IRS that accurately reflect their ability to pay while enabling the IRS to recover a reasonable portion of the outstanding debt in light of collectability issues.

One unfortunate and unintended consequence of making the OIC program more accessible is the inevitable administrative delay that will occur as a result of increasing demand. In March 2012, the Treasury Inspector General for Tax Administration reported that short staffing and strongly increased interest in the OIC program have resulted in backlogs and processing delays that are expected to affect a significant number of taxpayers.[18] Similarly, the Taxpayer Advocate has recognized that the IRS needs to make further adjustments and devote more resources to the OIC program to enable it to reap the benefits of the changes adopted to date.

Installment Agreements

A third potentially beneficial aspect of the Fresh Start initiative changes relates to installment agreements.[19] Much like the OIC program, installment agreements provide an option to taxpayers who are currently compliant, but cannot pay their entire tax bill by the due date. While the tax owed under an installment agreement is not reduced and interest continues to accrue on the outstanding balance, the taxpayer who enters into an installment agreement gets relief from penalties.

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Prior to the Fresh Start initiative, requests for installment agreements were subject to many of the same criticisms as the OIC program. Taxpayers applying for an installment agreement had to make significant financial disclosures and there were substantial delays in processing their request. In March 2012, the IRS announced two major developments in the installment agreement program. First, the maximum term for a payment plan was extended from 60 months to 72 months, enabling taxpayers to spread their payments over an additional year. Second, the IRS doubled the threshold for applying for a payment plan without having to provide an additional financial statement (from $25,000 to $50,000).[20] Finally, the Fresh Start initiative guarantees approval of an installment payment plan for taxpayers whose outstanding tax liability is less than $10,000.

Incentives to File

The economic downturn has made it difficult for many people to pay their tax obligations on a timely basis. From the taxpayer's perspective, however, it is essential to recognize that ignoring tax liabilities not only results in daunting tax liens with long-term financial consequences, but it also creates a risk of criminal prosecution. By adopting the Fresh Start initiative, the IRS appears to be making a concerted effort to bring delinquent taxpayers into compliance. It remains to be seen whether the IRS will devote sufficient resources to this initiative and whether taxpayers will take advantage of the benefits it offers.

1. A taxpayer has the right to a Collection Due Process hearing with the Office of Appeals to challenge the lien and request that it be withdrawn, released, discharged or subordinated.
2. See National Taxpayer Advocate, Annual Report to Congress 15-38 (2008).
3. Fair Credit Reporting Act, §605(a)(3), 15 U.S.C. §1681c(a)(3).
4. Press Release, National Taxpayer Advocate Delivers Annual Report to Congress: Focuses on Tax Reform, Collection Issues, and Implementation of Health Care Reform (Jan. 5, 2011).
5. See, e.g., National Taxpayer Advocate Report 432-47 (2007); National Taxpayer Advocate Report 17-40 (2009).
6. See National Taxpayer Advocate, Annual Report to Congress 141 (2006).
7. See National Taxpayer Advocate, Annual Report to Congress 85-93 (2010).
8. 133 T.C. 392 (Dec. 21, 2009).
9. Id. at 401.
10. Statutory authority for tax-liability compromise has existed since at least 1863, but the modern OIC program was created by Policy Statement 5-100, which formalized the procedures. IRM 1.2.14.1.17 (Jan. 30, 1992).
11. During the 2010 fiscal year, the IRS accepted approximately 25 percent of the offers it received. Overall, this was an acceptance rate of only one offer for every 290 delinquent accounts. IRS, Collection Activity Report No. 5000-02, Taxpayer Delinquent Account Cumulative Report (Oct. 1, 2010).
12. See, e.g., National Taxpayer Advocate, Annual Report to Congress 376-81 (2007); Treasury Inspector General for Tax Administration, Ref. No. 2010-IE-R002, The Internal Revenue Service Restructuring and Reform Act of 1998 Was Substantially Implemented but Challenges Remain 39-40 (2010).
13. IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes Made to Lien Process, IR 2011-20 (Feb. 24, 2011).
14. IRS, Collection Activity Report NO-5000-25, Liens Report (Apr. 2012).
15. Lien withdrawals are currently available only for individuals, not small business taxpayers. According to the IRS, the lien withdrawal program is intended for income tax liability, and not for delinquent gift, estate or employment taxes.
16. Through March 2012, the IRS issued 5,781 lien withdrawals under this program. See IRS, Collection Activity Report NO-5000-25, Liens Report (Apr. 2012). One potential concern with the Direct Debit program is possible debiting and recording errors by the Service. Since the IRS helplines are frequently difficult to reach, such issues could take a significant amount of time to resolve and may further impede taxpayers' efforts to comply with installment programs.
17. IRS Announces More Flexible Offer-in-Compromise Terms to Help a Greater Number of Struggling Taxpayers Make a Fresh Start, IR-2012-53 (May 21, 2012).
18. Treasury Inspector General for Tax Administration, Ref. No. 2012-30-033, Increasing Requests for Offers in Compromise Have Created Inventory Backlogs and Delayed Responses to Taxpayers (2012).
19. IRS Offers New Penalty Relief and Expanded Installment Agreements to Taxpayers under Expanded Fresh Start Initiative, IR-2012-31 (March 7, 2012).
20. The February 2011 announcement raised the threshold for small business taxpayers to participate in the installment agreement program from $10,000 to $25,000 in outstanding tax obligations. The maximum installment agreement term for small business taxpayers is 24 months.

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